

The KDM Dairy Report – September 19th, 2008

What's Bullish:

- Cash Market: Cheese prices continued to march steadily higher this week, virtually unopposed. Blocks gained 5¼¢ to settle at \$1.95½/lb and barrels picked up 5¢ to \$1.93¼/lb. One block trade was the only transaction the entire week. Butter made a new high for the year, settling at \$1.72½/lb, up 6½¢ on no trades. However, the rarely traded nonfat dry milk fell 12¢ in a single day today, settling at \$1.13/lb.
- Milk Production Report: August milk production in the U.S. was up 1.1%, the smallest increase this year. In addition, cow numbers fell 4,000 head from July, the first monthly drop since April, 2007. While most likely a result of the CWT herd retirement program, milk per cow also lower, falling 4 lbs/cow from last year and 26 lbs/cow from last month. Largest percentage increases were seen in the states of TX up 17.2%, KS up 15.6%, CO up 6.8% and ID up 6.3%. Notably, CA was down 1.9% while WI managed only a 0.9% increase.
- Livestock, Dairy & Poultry Outlook Report: USDA forecasts the 2009 milking herd to contract from 9.260 million head, down to 9.235 million head, due to higher feed costs and lower milk prices. Total milk production is expected to rise less than 1% from 2008 on account of the lower cow numbers and a less than 1% gain in milk per cow. The milk per cow increase forecast for 2009 is the smallest since 2004. However, there were several bearish aspects to the report as well (see below).
- Cheese production in the Midwest was unchanged to slightly lower this week, due to higher Class I demand, according to Dairy Market News. Domestic cheese inventories are being called adequate to somewhat tight, while interest in aged cheddar is building as fall approaches.
- Barrels, blocks and under grade cheese are all clearing very well in the Western region, according to Dairy Market News, as cheese buyers continue to build inventory for fall needs.
- Dairy Market News reports supplies of cheese in the Eastern region are getting tighter. Production is steady to lower at many locations as milk supplies are diverted to Class I use. Orders are higher for American and Italian varieties used for shredding.
- Demand for milk in the Central region was strong this week, according to Fluid Milk & Cream Review. Class I interest is above expectations for mid month, as bottlers continue to fill pipelines. Shipments into the Southeast were heavier this week, pulling more milk out of the Central part of the country. Manufacturers continue to look for additional supplies of milk, but are finding only limited volumes. Hurricane Ike greatly impacted milk logistics, with power outages causing some milk to be lost. Ice cream production remains stronger than expected in some areas, with some cream buyers needing to reach to Western suppliers to satisfy their needs.
- 327 loads of milk were shipped into the Southeast this week, compared to 290 last week. Fluid Milk & Cream Review reports milk is still tight in the Northeast and Mid-Atlantic regions as milk production is now near seasonal lows. Class I demand is strong, absorbing available volumes, with lighter volumes available for manufacturers.
- Milk production is holding fairly steady, but well off their highs, in the Western region, according to Fluid Milk & Cream Review. Plants in California, Arizona and New Mexico are still running on abbreviated schedules. In the Pacific Northwest, feed remains expensive, with alfalfa hay in tight supply. Farm level milk supplies are declining and tests are lower. Cheese plants in the region are noting good demand.
- Dairy Market News reports the butter market is firm, and demand for both domestic and international needs continues despite the highest prices since September 2005. Year-end needs will soon develop, leading some to believe price may push past \$1.74/lb.
- Weekly cold storage numbers continue to show a seasonal drawdown despite heavy production. For the period 09/01 through 09/15, butter stocks are down 2.25 million lbs and cheese stocks have fallen a more modest 138,000 lbs.
- Butter stocks at CME-approved warehouses fell a strong 4.9 million lbs for the week ending 09/13. That compares to a 2.5 million lbs drawdown during the same period last year, and leaves ending stocks at 73.5 million lbs, down 5 million lbs from year ago levels.
- Dairy cow slaughter continues to outpace last year's levels. For the week ending 09/06, 47,900 head were culled, compared to 43,200 during the same period a year ago.

Futures Month	Friday 09/19 Close	Friday 09/12 Close	Change
Sep-08	\$16.29	\$16.17	\$0.12
Oct-08	\$17.49	\$16.90	\$0.59
Nov-08	\$16.86	\$16.56	\$0.30
Dec-08	\$16.75	\$16.52	\$0.23
Jan-09	\$16.45	\$16.27	\$0.18
Feb-09	\$16.60	\$16.28	\$0.32
Mar-09	\$16.65	\$16.40	\$0.25
Apr-09	\$16.78	\$16.52	\$0.26
May-09	\$16.79	\$16.60	\$0.19
Jun-09	\$16.94	\$16.70	\$0.24
Jul-09	\$16.95	\$16.75	\$0.20
Aug-09	\$17.01	\$16.85	\$0.16
Sep-09	\$17.10	\$16.95	\$0.15
Oct-09	\$16.96	\$16.93	\$0.03
Nov-09	\$17.00	\$16.98	\$0.02
Dec-09	\$17.10	\$16.98	\$0.12
Sep-Dec	\$16.85	\$16.54	\$0.31
2009 Avg	\$16.86	\$16.68	\$0.18

- International: Cheese and curd exports for the first seven months of the year totaled 181 million lbs, 50% higher than a year ago, according to the Foreign Ag Service. Mexico imported the most, taking 46 million lbs. However, July exports were down 10% compared to June.
- International: The Foreign Ag Service this week reported dry whey exports from Jan-July were up 28%, and July exports were up 67% from the previous month. China, Canada and Japan represented the top three destinations.
- International: Nonfat dry milk exports were up 79% YTD through July, according to the Foreign Ag Service. However, July 2008 exports were down 33% from June. Mexico, the Philippines and Indonesia were the top three recipients.

What's Bearish:

- Livestock, Dairy & Poultry Outlook Report: While cow numbers are forecast to decline in 2009 and milk output will be up only slightly, USDA lowered their 2009 Class III price forecast by 35¢/cwt from last month, to an average of \$17.25/cwt. They cite softening demand both domestically and internationally as the main cause. The restaurant sector is expected to underperform, due to our slowing economy, while the dollar strengthening against the Euro, and increasing foreign milk production is expected to slow exports.
- Dairy Market News reports that the nonfat dry milk market is weak as inventories continue to build around the country, despite a slowdown in drying. Producers are being forced to discount loads in order to move product, while buyers wait for a bottom and are holding off on all but hand-to-mouth purchases.
- Western dry whey prices were sharply lower this week, according to Dairy Market News. Sellers are being aggressive with pricing to keep powder moving and not letting stocks grow. Competition from other exporting countries is growing, putting further pressure on prices.
- Weekly NASS prices were lower for most Class III components this week. 40-lb blocks decreased 1.8¢ from the previous week to average \$1.72/lb, but 500-lb barrels increased 1.9¢ to \$1.71/lb. Butter was up slightly at \$1.61/lb, but nonfat dry milk plunged 11.4¢ to average \$1.21/lb and dry whey decreased 0.6¢ to 22.2¢/lb.
- An article released by the Dairy Business Association concludes Wisconsin milk production could exceed plant capacity within the next few years, unless new investments are made. Positive returns over recent years have seen both the number of cows and milk per cow increase. Producers are expanding and plan to invest \$116 million this year alone in capital improvement projects.
- International: Tainted milk in China! The last thing we need is for the Chinese consumer to be wary of and avoid dairy products. But baby formula tainted with melamine killed four infants and sickened 6,200. Parents by the thousands were bringing their children to hospitals for health checks. 158 newborns are in hospitals, suffering from acute kidney failure. Now the scandal has widened to fluid milk, after tests found melamine contamination in liquid milk produced by three of the country's leading dairy companies.
- International: Dairy prices in Oceania slumped in August as the U.S. dollar was up sharply against other currencies, according to a new article this week. Rabbobank analysts also said that U.S. milk supply growth was staying stronger for longer than expected and Brazil's export surplus was growing rapidly. Weak consumption growth in the U.S. and EU is forcing more product onto the international market than would otherwise have been the case.

Recommendation:

Class III contracts all finished higher this week on the continued run-up in cheese prices. In light of the international picture and our own questionable economy, we remain skeptical that cheese prices will be able to maintain these prices for much longer. The current dairy health scare in China is something to watch. Sure, there are lots of bullish points this week on our somewhat tight milk and cheese supply, but that's because buyers are still buying for fall. We're hearing about lots of cows freshening in October. Combine that with buyers pulling away, and suddenly we're in a surplus situation again. October Class III exceeded our expectations this week, moving through the \$17.20 target we set last week. Great! Sell more if prices keep heading higher this week. Continue to target to sell November at \$17.00 or higher, which it briefly did this week, and sell December at \$16.90 or higher. Get that done and you'll have sold your milk for nearly \$1.90 cheese through the end of the year (unless the new make allowance doesn't go through). We just don't believe cheese prices can be sustained that high for that long. Even price action today demonstrates that belief. Block cheese went up 3¼¢ in today's cash session, yet October, the front month, finished 6 lower on the day. **Get something done now!** For 2009, target Q1 at 16.80 or higher. Leave the last half of 2009 alone.

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